price would not permit payphone providers to recover fixed costs. Thus each payphone user bears the same proportion of the burden of covering those fixed costs -- costs that must be recovered if there is to be widespread deployment. It is "fair" for each user to make such an equal contribution. Hausman Decl. ¶ 9.

Finally, the avoided cost price is fair in the sense that it ensures that the opportunity cost of each type of call will be the same. Even when a payphone is not fully utilized at all times, the use of a payphone for one type of service imposes an opportunity cost on the payphone provider measured by the probability that the call will prevent the use of the payphone for other types of calls. Under these circumstances, firms have an incentive to equalize the recovery of joint and common costs among call types. See Becker Decl. ¶ 30. By ensuring that the opportunity costs of local calls and compensable coinless calls will be the same, the avoided cost technique likewise ensures that payphone providers will be indifferent among these different call types.

IV. AVOIDED COST PRICING IS AN APPROPRIATE RESPONSE TO THE PROBLEM OF SETTING THE PER-CALL COMPENSATION DEFAULT RATE

Avoided cost pricing is appropriate where three conditions are satisfied:

-- There is a single facility used to provide more than one service;

-- At least one of the services is sold in a competitive market; and

-- The differential costs between the services are calculable.

See Becker Decl. ¶ 16; Kahn Decl. at 4-5; Hausman Decl. ¶ 18. All these conditions are met here.

First, the same payphone is used to provide service to local callers, calling card callers, callers to 800 subscribers, and so on. It has been objected that it is unreasonable to derive a market-based rate for dial-around and subscriber 800 calls from the market rate for local coin calls because the markets are different. See, e.g., AT&T Petition for Reconsideration at 5 (filed Dec. 1, 1997).[12] But the relevant fact is that from the supply side the various categories of calls are common products, supplied by the same facility -- indeed, AT&T's own expert was forced to concede that the two calls are related on the supply side. See Kahn Decl. at 4 n.5; AT&T Reply Comments on Remand, Warren-Bolton Decl. at 2 (filed Sept. 9, 1997). As Professor Kahn explains, "if the market price of the one may properly be regarded as reflecting the cost of supplying it, so may the regulated price of the other be based on that same market price, provided only that it is adjusted for any differences in their several costs, as the FCC has attempted to do." Kahn Decl. at 5; see also Hausman Decl. ¶ 12; Becker Decl. ¶ 35 ("[T]he market-determined rate for providing access for local coin calls appears to be sensible competitive benchmark for establishing rates for other payphone access services.").

Second, the payphone market is highly competitive, and the local coin rate is a genuine market rate that reflects PSPs' costs. See Hausman Decl. ¶¶ 19-22. That the market is not perfectly competitive -- that prices include a mark-up to cover fixed costs, as well as marginal costs -- does not detract from the validity of the Commission's approach.[13] So long as the market is effectively competitive -- as it must be to maintain the local coin rate at reasonable levels -- the avoided cost approach is appropriate.

In the First Report and Order, the Commission found that "the payphone industry has the potential to be very competitive." 11 FCC Rcd at 20547, ¶ 11. The reasons for the

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[12]As Professor Kahn explains, AT&T misconstrues the testimony of its own expert in claiming that the FCC's avoided cost technique is unreasonable. See Kahn Decl. at 5-6.

[13]Indeed, Professor Becker explains why the mark-up to cover fixed costs would exist even in a market that could be considered perfectly competitive. See Becker Decl. ¶ 26.

Commission's conclusion are clear. There are no barriers to entry into the payphone market: "The ability to purchase a payphone, secure a location contract, obtain a payphone line from the LEC, and maintain the payphone are, together, the minimal technical requirements to enter into the payphone business." Id., see also Order on Recon., 11 FCC Rcd at 21267, ¶ 68 ("[T]he presence of multiple PSPs already operating in many markets, and the structure of the industry that allows relatively easy entry and exit, leads us to conclude that we can rely on market forces to provide for efficient pricing of these services in the near future.").

The record before the Commission in 1996 showed that, at that time, "a large number of firms, both large and small, [had] entered the industry since it was initially opened to competition in 1984." First Report and Order, 11 FCC Rcd at 20548, ¶ 12. Significantly, the Commission found that "the average BOC payphone originates about 500 calls per month while the average independent payphone originates about 700 calls per month." Id. at 20548 n.28. These numbers bear out what common sense would have suggested: lower-volume payphones simply did not cover the costs of the payphone at the regulated rate; only at the highest-volume locations could a competitive market develop.

Although the payphone market has been deregulated nationwide less than a year, the effects of increased competition are already apparent. The number of payphones owned by LECs has decreased, while the number of payphones owned by independent providers has increased sharply, indicating the ease of entry and rapid deconcentration of this previously regulated market. Indeed, the Coalition's share of total payphones has decreased by four percentage points in one year alone.[14] See Andersen Decl. at 10. IPPs are increasingly able to compete with LECs for all economical payphone locations. Over time, the industry is likely to become still more competitive, as per-call compensation payment arrangements become more reliable and the independent PSP industry is no longer hampered by the sort of cash-flow crisis that has plagued it over the last year. See Payphones II, Transcript of Oral Argument at 16-22. Already, the payphone market is characterized by low market concentration. There are thousands of payphone providers. The size of the largest independent provider now rivals that of the smallest RBOC PSP, U S WEST. See generally Hausman Decl. ¶ 22.

More important, the Commission has rightly determined that the payphone market is structurally competitive. There are no significant barriers to entry into the payphone market; where barriers to entry are low, a firm generally cannot exercise market power. See Becker Decl. ¶¶ 36-37; Hausman Decl. ¶ 19; Kahn Decl. at 2-3; see also Justice Department and FTC Horizontal Merger Guidelines, ¶ 3.0 ("In markets where entry is . . . easy (i.e., where entry passes . . . tests of timeliness, likelihood, and sufficiency), [a] merger raises no antitrust concern and ordinarily requires no further analysis.").

This is, in fact, ground that the Commission has already covered. The Commission's decision to deregulate the local coin rate itself reflected the Commission's determination that the payphone market was structurally competitive, and that the Commission could rely on competition to ensure fair compensation. See First Report and Order, 11 FCC Rcd at 20570, 20572, ¶¶ 56, 60; Order on Recon., 11 FCC Rcd at 21258-59, 21265, ¶¶ 50, 62. "[T]he presence

[14]Collectively, the seven members of the Coalition own only about two-thirds of the country's payphones. Moreover, since many of those payphones tend to have lower traffic volumes, the Coalition's share of payphone traffic is even smaller.

of multiple PSPs already operating in many markets, and the structure of the industry that allows relatively easy entry and exit, leads us to conclude that we can rely on market forces to provide for efficient pricing of these services in the near future." Id. at 21267, ¶ 68. The Commission has clearly expressed its "confiden[ce] that market forces will keep payphone prices at competitive levels." Second Report and Order, 13 FCC Rcd at 1829, ¶ 118.

The D.C. Circuit affirmed that finding. The Court held that "it was not unreasonable for the Commission to conclude that market forces generally will keep prices at a reasonable level." Payphones I, 117 F.3d at 562. As Professor Kahn has explained, there is simply no way to understand this finding other than as a finding that the payphone market is generally sufficiently competitive to keep prices at the level of costs. See Kahn Decl. at 3 ("A statement that 'market forces' will keep prices at [a reasonable] level is -- in both longstanding regulatory parlance and elementary economic principle -- at one and the same time a justification for deregulating the market and a conclusion that 'coin call rates converge with costs.'").

Moreover, settled regulatory doctrine in other regulated industries similarly holds that a market-based rate can be considered reasonable only if the market is sufficiently competitive to ensure that prices will reflect costs. See Louisiana Energy & Power Auth. v. FERC, 141 F.3d 364, 365 (D.C. Cir. 1998) ("Where there is a competitive market, [FERC] may rely on market-based rates in lieu of cost-of-service regulation to ensure that rates" are just and reasonable); Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870-71 (D.C. Cir. 1993) (finding that company "will not be able to raise its price above the competitive level without losing substantial business to rival sellers" supported decision to set a market-based rate); Tejas Power Corp., 908 F.2d at 1004. In other words, when the D.C. Circuit affirmed the FCC's determination that "market forces generally will keep prices at a reasonable level," it necessarily implied both that the FCC had found that the local coin market was competitive and that this determination was reasonable. Given this record, the Commission need not revisit this analysis; it should merely reaffirm it.

Third, and finally, the Commission has correctly concluded that the differential costs between local coin calls and coinless calls are calculable. Some adjustments to the Commission's calculations are appropriate -- because the Commission made both economic and accounting errors -- but no one has disputed that the analysis can be carried out.

Accordingly, all the conditions appropriate to an avoided cost analysis based on the local coin rate are satisfied.

V. THE VARIOUS OBJECTIONS RAISED TO THE COMMISSION'S AVOIDED COST APPROACH ARE UNFOUNDED

The carriers who benefit from dial-around and 800 access code calls have raised several objections to the Commission's avoided cost approach. They have claimed that the local coin rate will be distorted by locational monopolies and by the fact that it can only change in five cent increments. They have also argued that 800 subscriber calls should be treated differently because the caller does not bear the per-call compensation charge and thus has no incentive to select a less expensive payphone. None of these objections has merit. None should cause the Commission to alter its approach.

A. The Locational Monopoly Objection Is Empirically Unsupported and Logically Implausible

At the time of the First Report and Order, the Commission cited three potential barriers to full competition in the payphone market. The first of these -- state regulatory barriers -- has generally been removed in the wake of the Commission's Payphone Orders. See generally First

Report and Order, 11 FCC Rcd at 20548, 20567, ¶¶ 13-14, 49. A second barrier -- the possibility that consumers would lack information concerning payphone rates -- is the subject of regulation in the Payphone Orders and the Billed Party Preference order.[15] Finally, the Commission expressed concerns that there might be locations where, "because of the size of the location or the caller's lack of time to identify potential substitute payphones, no 'off premises' payphone serves as an adequate substitute for an 'on premises' payphone." First Report and Order, 11 FCC Rcd at 20549, ¶ 15.

The bête-noir of "locational monopoly" should not cause the Commission undue concern. As an initial matter, under no theory can a PSP earn a monopoly profit from such a location. That is because for any such location, there are likely to be dozens of PSPs competing for contracts. If there are any economic rents to be earned, it is the location provider who will reap them, not the PSP. Of course, in most cases, there is no reason to believe that the location provider would earn any economic rent, for the value of the location will presumably be reflected in the market price of the property.

It is then only in cases where a location is isolated as a result of regulatory barriers that such economic rents are at all likely to be possible. For example, in the case of airports and interstate highway rest stops, the municipal or state government is likely to control access to the facility. Yet the governmental authorities who control such facilities may be reluctant even to attempt to exact monopoly rents for such services as access to payphones. Not only would such

[15]See Billed Party Preference for InterLATA 0+ Calls, CC Docket No. 92-77, FCC 98-9 (rel. Jan. 29, 1998).

an authority risk an adverse consumer reaction, but political damage as well.[16] Perhaps in theory an airport authority could increase commission revenues by requiring the PSP to raise its local coin rate to $.50,[17] but in fact airport authorities have not attempted to do so.[18] See Hausman Decl. ¶ 22.

Just as important, it is hard to credit claims that the problem of locational monopolies is likely to be widespread. In the typical case of a hotel, restaurant, street corner, retail store, or gas station, a PSP would clearly be unable to set the price for local coin service, but must instead take the price for such service from the market. See Kahn Decl. at 2-3 ("Entry into the [payphone] market is easy; and the combination of requirements for clear disclosure of charges . . . and the impracticability of payphones discriminating between informed and uninformed, discretionary and emergency callers could clearly, in my judgment, justify a conclusion that any locational monopoly made possible by buyer ignorance or the inconvenience of shopping around does not render unregulated competition insufficient to protect consumers.") Only where a

[16]There are also reasons that a PSP might be reluctant to charge higher rates in such locations, including damage to the PSP's brand image. Of course, PSPs might set up off-brand operations to charge higher rates -- as many IXCs have done -- but there is no evidence that PSPs have done so.

[17]Even here, though, wireless alternatives and the possibility of temporal substitution will keep prices in check. Since demand for local coin calling is highly elastic, any such strategy is unlikely to be profitable.

[18]It is, in any event, fallacious as a matter of economics to suggest that because payphone rates may be higher in certain locations, this reflects market power. Consumers frequently pay higher prices for commodities in certain locations; this generally reflects the value to the consumer of this service. For example, one might pay $.25 for a candy bar bought in a package of 12 in the grocery store; $.50 for the same candy bar in a convenience store, $.75 in a vending machine, and $2.00 in a movie theater. Yet no one would seriously contend that the market for candy bars is not fiercely competitive, nor that any of the vendors of the products had earned a monopoly profit.

higher rate is justified by higher costs or lower volumes -- as in the case of remote locations, for example -- is a PSP likely to sustain such a rate over time.[19] Indeed, the D.C. Circuit noted that no party to this proceeding had presented "any evidence that there are significant locational monopolies in the states that have already deregulated their local coin rates." Payphones I, 117 F.3d at 562. A year later, there is still no such evidence.

Moreover, the Commission has already put a mechanism in place for addressing the problem of monopoly rates, should the problem arise. The Commission decided that it "should make an exception to the market-based approach for states that are able to demonstrate to the Commission that there are market failures within the state that would not allow market-based rates." First Report and Order, 11 FCC Rcd at 20572, ¶ 61; see Payphones I, 117 F.3d at 562-63. The Commission invited the States to recommend Commission action in the case of such market failure. No State has done so.

Finally, the Commission's rate of per-call compensation, at least until October 1999, is a uniform one. Because the market rate generally reflects costs (even if in some locations a provider were able to charge a rate in excess of cost), the Commission's default rate similarly reflects overall market costs. The problem of locational monopoly does not have any impact on the per-call compensation rate during this transition period, because an individual provider cannot affect that rate.

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[19]Nor would a location provider be likely to be able to extract any economic rent or to insist on a higher rate for payphone services. In a competitive market, a price above the market price will sharply depress demand for a service. See, e.g., Elizabethtown Gas, 10 F.3d at 871. Because location providers are typically compensated on a percentage basis, this would not be in the interest of the location provider.

B. The Five-Cent Increment Objection Ignores Basic Economics

Some carriers have suggested that, because payphones do not accept pennies, the market rate may exceed costs to the extent that the PSP has "rounded up" the price of a call to the nearest nickel. This suggestion is an economic canard.

Under conditions of free entry, PSPs will expand their operations until rates are equal to costs. Suppose that the costs of a marginal payphone are $.35, and the government eliminates a 7% excise tax on such calls so that the cost decreases to $.33. No PSP will be able to reap economic rent as a result of this change, not because the rate will decrease to $.33, but because the supply of payphones will expand in the market until the costs of a marginal payphone again equal $.35 per call. "The competitive response of expansion or entry will drive out economic rents or above-normal profits; they will be competed away." Hausman Decl. ¶ 27; see Becker Decl. ¶ 38.

The objection is fallacious for an additional reason. No party has suggested why the rounding to the nearest nickel would, on average, be upward rather than downward. "If the market for coin calls were effectively competitive, the roundings upward would be balanced or offset, systematically, by the roundings downward. Prices would move by 5 cent intervals; but if the roundings were asymmetrically upward, as the objections implicitly assume, the incumbent firms would earn supernormal profits, which entry would undermine." Kahn Decl. at 15.

The five-cent increment objection is not only fallacious, but it is also insidious. To the extent that the Commission would determine whether this alleged market imperfection were inflating the local coin rate by performing an estimate of costs, the Commission would effectively have to abandon a market-based approach in favor of a cost-based approach. If the

Commission were to adjust the market-determined rate to reflect the extent to which the local coin rate supposedly exceeds costs, the "market-basis" for the default rate would be mere window-dressing.

C. Avoided Cost Pricing of Subscriber 800 Calls Is Appropriate

Opponents of the Commission's avoided cost pricing have realized that they are getting a bargain by paying only $.284 for access code calls; not surprisingly, most of their arguments ignore such calls completely and focus on objections to the default rate for subscriber 800 calls. For example, it has been objected that while local callers have an incentive to select a less expensive payphone, callers to subscriber 800 numbers have no such incentive because it is the 800 number subscriber who ultimately will bear the cost of the per-call compensation charge. This objection is wrong for several reasons.

First, the very virtue of avoided cost pricing is that it permits the establishment of a market-based rate where market failure prevents the market from operating directly. So long as the local coin market is effectively competitive -- and it is -- the local coin rate will remain reasonable, that is, it will reflect PSPs' costs. The market-based dial-around default rate, too, will also reflect costs, for the reasons already described in detail above. See Kahn Decl. at 9.

Second, during the transition period that continues until October 1999, a PSP simply cannot increase compensation for coinless calls by increasing the local coin rate; instead, the default rate during this period is set at a uniform national rate.

Third, IXCs have insisted on the need for payphone-specific coding digits on all payphone lines to permit them to carry out "targeted" call blocking. The Commission has required LECs to implement Flex ANI to ensure that such payphone-specific digits will be available on smart and dumb payphone lines alike; the implementation of Flex ANI is widespread today and by the expiration of the transition period will be virtually universal. Thus, IXCs have significant leverage to negotiate a lower rate for compensation for subscriber 800 calls. See Order on Recon., 11 FCC Rcd at 21268-69, ¶ 71; Payphones I, 117 F.3d at 564-65.[20] In other words, 800 subscribers can shop around for less expensive payphones. Hausman Decl. ¶ 30; Kahn Decl. at 16-17.

Moreover, the Commission's decision to impose the payphone compensation fee on the 800 subscriber, rather than the caller, is simply a particular example of the general rule that the called party, rather than the calling party, pays toll charges associated with calls that are "toll-free" to the caller. If an 800 subscriber chooses not to accept calls from payphones because of the additional cost, this is simply a marketing decision for that subscriber.[21]

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[20]In fact, despite the widespread availability of FLEX ANI (for free), carriers have not been ordering it. This is a strong indication that the per-call rate is not causing problems for 800 subscribers. Otherwise, they would demand targeted call blocking and carriers would be rushing to provide it.

[21]For these reasons, the Commission should not reconsider its decision to reject a calling party pays compensation scheme for subscriber 800 calls. The Commission has noted that "the carrier-pays system . . . gives IXCs the most flexibility to recover their own costs, whether through increased rates to all or particular customers, through direct charges to access code call or subscriber 800 customers, or through contractual agreements with individual customers." First Report and Order, 11 FCC Rcd at 20584, ¶ 83. The Commission further concluded that "the marketplace will determine, over time, the appropriate options for recovering these costs." Id.

The Commission considered and rejected a "caller-pays" compensation system for several reasons. First, requiring the deposit of coins would unduly burden many transient payphone callers. Id. at 20585, ¶ 85. Second, the Commission noted that TOCSIA would bar this approach for 800-access code numbers. Id. In its Order on Reconsideration, the Commission observed that rejection of caller-pays was consistent with the Commission's long-held view that "callers should not be required to deposit coins when making a call that i[s] otherwise billed to an account." 11 FCC Rcd at 21275, ¶ 88. And the Commission also found that its carrier-pays system was consistent with the provision of the Act that prohibits carriers from assessing the calling party a charge for completing any 800 number call. Id. at 21275, ¶ 88. The D.C. Circuit

Finally, dial-around and subscriber 800 calls are appropriately compensated at the same rate and in the same way for two additional reasons. First, no party has established that there are any cost differences between subscriber 800 calls and dial-around calls. Under the Commission's avoided cost approach, the two services should therefore be priced at the same level. Second, if PSPs were compensated at a lower rate for subscriber 800 calls, carriers would simply set up regenerated dial-tone operations using 800 numbers to gain an advantage in the provision of long distance service from payphones. See Hausman Decl. ¶ 31. IXCs are free to allocate per-call compensation obligations differently among their 800 subscribers and long distance subscribers, but regulatory barriers prevent PSPs from doing so.

VI. THE COMMISSION SHOULD PERFECT ITS AVOIDED COST CALCULATION ON RECONSIDERATION

In its Petition for Reconsideration, the Coalition pointed out several flaws in the Commission's application of its avoided cost methodology that should be corrected on reconsideration. Two issues were of particular concern: the Commission's treatment of coin mechanism costs and its treatment of Flex ANI costs. In addition, the Coalition noted that -- based on the data then before it -- the Commission had overstated line savings, and that the Commission had improperly treated bad debt and collection costs associated with per-call compensation as non-existent.

Professor Kahn addresses the issue of coin mechanism capital costs in his declaration. Like Professor Hausman before him, Professor Kahn confirms that the Commission made a simple economic error in treating coin mechanism capital costs as avoidable costs of local coin

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upheld the Commission's conclusions. Payphones I, 117 F.3d at 567.

calling. In addition, the Coalition has documented the costs of Flex ANI and demonstrates that the cost of the service comes to about $.01 to $.02 per compensable call. Once the Commission makes these and other required adjustments on reconsideration, the per-call compensation rate should be at least equal to the local coin rate.

A. Coin Mechanism Costs Are Not Avoidable

In its Petition for Reconsideration, the Coalition explained that the coin mechanism and coin box are not avoidable costs because most payphones simply would not exist but for the coin mechanism. Professor Kahn expands upon this point in his declaration. He states that as long as the fixed costs associated with the coin-collection mechanism would not be altered if, within the likely range, the volume of coinless calls increased or decreased, then the coin mechanism costs are neither more nor less avoidable costs of coinless calls than of coin calls. See Kahn Decl. at 10-11.

The purpose of setting a price that reflects the costs of a particular service is to require the potential buyer of that service to decide whether the incremental costs to society of demanding more of the service is less than the value to the buyer of the service in question. If the additional payphone that will be installed as a result of an increase in demand for coinless payphone services is likely to be a coin-capable phone -- and no one has seriously questioned that it would be -- the coinless caller should bear a fair proportion of the total cost of the phone, not the costs of the phone without the coin mechanism.

Though it might strike a non-economist as "unfair" to require coinless callers to pay for a capability of the payphone that they do not use, this appearance of unfairness is illusory. That is because it is in fact more costly to provide dial-around and subscriber 800 callers with coinless phones, rather than with coin phones, because, as the Commission has recognized, the per-call costs of providing such phones is actually higher than the per-call costs of providing a coin-capable instrument. See Kahn Decl. at 14; Coalition Petition for Reconsideration at 10-11; Second Report and Order, 13 FCC Rcd at 1797, 1824, ¶¶ 45, 108. Thus the coin mechanism in fact provides a benefit to all callers, even those who do not deposit coins. See also Andersen Decl. at 7. The Commission thus erred by treating coin mechanism costs as avoidable, and it should adjust the default rate on reconsideration to correct this error.

B. Flex ANI Costs Are Between $.01 and $.02 Per Call

In its Petition for Reconsideration, the Coalition asked that the Commission correct two errors in its treatment of Flex ANI costs. The first error is that the data upon which the Commission originally relied were flawed. The second error is that the Commission clearly should have allocated Flex ANI costs to coinless calls alone, rather than to all calls.[22]

The Coalition has requested data from each of its members to determine the correct costs of Flex ANI implementation. As the attached report, prepared by Arthur Andersen, documents, Coalition members have already incurred, or expect to incur, monthly Flex ANI charges of

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[22]As with coin mechanism costs, there is a legitimate question as to whether Flex ANI costs should be treated as avoidable costs. The answer depends in part on how LECs choose to recover such costs. If Flex ANI were tariffed on a per-use basis, then the cost would indeed be an avoided cost, and the default rate should be adjusted upward to account for it. But if, as currently appears likely, Flex ANI were charged on a flat-rated, per-line basis, then the PSP could not reasonably avoid the cost. At a minimum, however, the Commission must treat Flex ANI costs and coin mechanism costs symmetrically: if coin mechanism costs are allocated to coin calls alone, then Flex ANI costs must similarly be allocated to compensable calls alone; thus, the Commission's asymmetrical treatment of such costs in the Second Report and Order was clearly incorrect.

between $1.17 and $2.45 per payphone line.[23] See Andersen Decl. at 4. Based on the Commission's calculation of 116 compensable coinless calls at each marginal payphone, see Second Report and Order, 13 FCC Rcd at 1800, ¶ 50, this works out to about $.01 to $.02 per call. The Commission should increase its adjustment for Flex ANI costs to reflect these data.

C. The Net Avoided Cost Is About $.00

The Coalition has documented the costs of local line charges and has determined that such costs amount to $.025 to $.03 per call, which is consistent with the Commission's findings in the Second Report and Order. The Coalition therefore withdraws its prior objection on this point.

As to bad debt and collection expenses, however, the Andersen study confirms that it is inappropriate -- indeed, arbitrary -- to treat such expenses as though they did not exist. Administrative expenses associated with per-call compensation alone are up to eight-tenths of a cent per compensable call. See Andersen Decl. at 5-6. And Coalition members estimate that per-call compensation uncollectibles will range from 3 to 10 percent of total expected per-call compensation revenue. See id. at 6. The Commission should take these amounts into account.

The Andersen study demonstrates an additional error in the Commission's Second Report and Order, one that did not become apparent until the method of invoicing and remitting per-call compensation payments was clarified by the Common Carrier Bureau. See Bureau Coding Digit Waiver Order, DA 98-481 (rel. Mar. 9, 1998). Because IXCs are to remit per-call compensation payments on a quarterly basis, there will be up to a six-month lag between the time the IXC

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[23] These charges will be in effect for two years (and in one case, one year). See Andersen Decl. at 4 n.5.

incurs the obligation and the time of payment. For this reason, the Commission understated the interest cost of delay in payment; the proper figure is $.011 per call, rather than the $.008 used by the Commission. See Andersen Decl. at 5.

The bottom line: the net avoidable costs of coinless calling as compared to coin calling are between $.015 and minus $.018.[24] See id. at 9. In other words, they are about zero. The Commission should therefore set the per-call compensation rate equal to the local coin rate.

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[24]If Flex ANI costs are treated as not avoidable, the avoided costs are between about $.025 and $.003 per call.

CONCLUSION

For the foregoing reasons, the Commission should reaffirm its commitment to set a market-based default rate for per-call compensation, adjusting the competitive local coin rate for the net avoided costs of coinless calling. Because those net avoided costs are about zero, the per-call compensation default rate should be equal to the local coin rate.

Respectfully submitted,

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July 13, 1998

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DECLARATION OF GARY BECKER

July 10, 1998

I. INTRODUCTION

1. My name is Gary S. Becker. I am University Professor of Economics and Sociology at the University of Chicago. I am also a Senior Research Associate of the Economics Research Center of the National Opinion Research Center, and a Senior Fellow of the Hoover Institution at Stanford University. I am a member of the National Academy of Sciences, the Econometric Society, the American Statistical Association, and I am a member of past president of the American Economic Association. I am the recipient of the 1992 Nobel Memorial Prize in Economics. I have written widely on a variety of economic topics, including economic theory, human capital, the economics of crime, the economics of discrimination and the economics of the family. My curriculum vitae is attached to this affidavit.

2. I have been asked by counsel for the RBOC/GTE/SNET Payphone Coalition ("Coalition") to evaluate the FCC's proposed methodology for determining the appropriate compensation to Pay Service Providers ("PSPs") for 800 subscriber and dial-around access calls. As part of my work in this matter, I have reviewed the May 15, 1998 decision by the U.S. Court of Appeals on this issue, the FCC's Second Report and Order regarding payphone compensation rules (October 9, 1997); the FCC's First Report and Order regarding payphone compensation rules (September 20, 1996), as well as various filings to the Court of Appeals and the FCC made by the Coalition and other parties, including AT&T and MCI.

3. Based on my experience and expertise as an economist and my review of these

materials, I conclude that the "avoided cost" methodology proposed by the FCC is a reasonable and economically appropriate framework for establishing compensation for dial-around and 800 calls from payphones. Properly applied, this framework yields a level of compensation to payphone service providers that approximates what would arise in a competitive market. I also conclude that the "cost-based" methodologies proposed by some of the intervenors and firms that have commented in this proceeding are flawed. They would yield levels of compensation below what would arise in a competitive market and, therefore, would lead to an inefficient restriction of payphone services.

4. This Declaration sets out in greater detail the basis for my conclusions and is organized as follows: Section II presents an overview of the essential features of the payphone industry as they relate to this matter. It presents a detailed overview of my conclusions. Section III analyzes the principles that determine prices that payphone service providers would be expected to charge under competitive conditions for the various access services they provide. Section IV presents my conclusions.

II. BACKGROUND AND OVERVIEW

5. Payphone service providers (PSPs) provide payphone users with a variety of different access services. These include: (i) access to the telephone network for local and toll calls; (ii) access to a default long distance provider assigned to the payphone; (iii) "dial-around" access to a long distance provider other than the default carrier assigned to the phone; and (iv) access to 800 subscriber calls, for which the recipient pays.

6. PSPs provide access to the local telephone network by contracting with location providers, such as airports and service stations, which own the sites where payphones are located. PSPs obtain access to the local exchange carrier's network at tariffed rates. Location

providers or PSPs contract with long distance companies to become the default long distance provider for consumers that do not choose to select an alternative carrier. Payphone users usually deposit coins to pay for local calls; in some circumstances local calls as well as "zero plus" calls are "coinless."

7. PSPs are required to provide access services: (i) to consumers who wish to "dial around" the default long distance carrier and obtain access to an alternative long distance carrier; and (ii) to consumers who wish to make "800" calls from payphones. Although PSPs provide an essential service required for completion of these calls (access to the telephone network) they previously were not compensated for doing so. This is the consequence of their legal duty to permit payphone users to dial access code numbers (including 800 access codes) from their payphones. Under these circumstances, the (non-default) long distance carrier had no reason to compensate the PSP for providing service in delivering customer calls. Similarly, 800 call recipients had no reason to provide such compensation to PSPs.

8. The courts and the FCC have struggled to determine an economically efficient mechanism for remedying this heretofore failure in regulation. Most recently, the FCC has adopted the use of an "avoided cost" methodology for determining compensation to be paid to PSPs for dial-around and 800 calls. This methodology is based on the (market-determined) coin rate less an adjustment that reflects the costs that are "avoided" in providing access for dial-around and 800 calls compared to local coin calls. The Court of Appeals is unconvinced that this procedure is economically appropriate. Other parties, principally AT&T and MCI, have advocated a cost-based approach to determining compensation for dial-around and 800 calls.

9. My attempts to evaluate the appropriate price for compensating payphone providers for dial-around and 800 access adopts as a standard the prices that would be expected to emerge in a competitive industry with similar production and cost characteristics.

10. A crucial industry characteristic that must be considered in making this evaluation is that the provision of various payphone access services involves significant common costs (such as many costs associated with the payphone instrument itself). There also are certain costs that are attributable to particular services. For example, local coin calls require equipment to monitor and collect the coins that are inserted. This equipment must be serviced and emptied of accumulated coins on a regular basis.

11. Despite these complications, a simple competitive model provides significant guidance for evaluating the economically efficient price for dial-around and 800 services. Although actual market conditions may deviate from the competitive benchmark for a variety of reasons (such as imperfect information among consumers), this benchmark still provides useful guidance for evaluating the FCC's avoided cost methodology and other proposals to address the market's failure to price access for dial-around and 800 calls.

12. As described in more detail below, my analysis indicates that under competition, the price for each type of payphone access services would exceed the marginal or variable cost of providing the last unit of output. The competitive model also implies that firms that provide multiple services with common facilities and fixed costs will equalize margins (defined as price less the marginal cost of providing a unit of service) between each of the various types of access services.

13. In principal, the FCC's "avoided cost" methodology for determining compensation for dial-around and 800 calls would achieve the equalization of margins that would be observed under competitive conditions.

III. COMPETITIVE PRICING OF PAYPHONE ACCESS SERVICES

14. While the payphone industry involves significant institutional complexities, the appropriate level of compensation for dial-around and 800 calls can be evaluated with the relatively straightforward microeconomic framework used to analyze pricing in industries where a common set of inputs help produce multiple services.

15. This process by which prices are determined in such an industry can provide significant guidance to regulators in terms of establishing the appropriate prices for dial-around and 800 calls. As mentioned above, I adopt as a standard the prices that would emerge in a fully competitive payphone industry with no unpriced outputs.

16. As noted above, payphones provide several services. Many of the costs of providing such services are "common" in the sense that they cannot be uniquely assigned to the provision of any particular service. However, it may be possible to identify certain costs that are specific to the provision of a particular service.[1] Such circumstances are not unique to the payphone industry. The following example illustrates how competitive markets function under similar production and cost conditions.

A. AN ILLUSTRATIVE EXAMPLE

17. Consider a simple example of hair stylists who provide services for both men and women. The production of hair styling services is assumed to involve certain fixed or "lumpy" common costs, such as rent, etc., that are not specific to providing service to either men or women. The production of hair styling services also involves certain variable costs, such as the

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[1] I understand that there are significant disagreements between various commenting parties with respect to which costs can be uniquely assigned to a particular service. These issues are not addressed in this affidavit.